Analysis of Flat Tax Implementation in the United States

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by

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Abstract

The income tax system in the United States is very controversial, and it is constantly being debated. The current system has deductions, credits, and graduated marginal tax brackets; it is progressive in nature. Many politicians, both in the past and presently, have advocated for abandoning the current tax code in favor of a "flat tax." By definition, a pure flat tax taxes every dollar of income at the same percentage, regardless of the taxpayer's income level; it is not progressive. In this paper, I will explain both the current tax system and what possible flat tax systems might look like in the United States. I will then detail and analyze arguments on both sides of the flat tax debate.

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I. INTRODUCTION

The tax code is one of the most consistently debated topics in the American political arena. The current code has many criticisms, and politicians on both sides of the political aisle have advocated for eliminating it in favor of a "flat tax." This paper will explain how the tax system functions currently and how it would work under a flat tax. It will then detail arguments in favor of replacing the current tax system with a flat tax, and it will also describe the arguments against implementing a flat tax. The federal income tax on individuals represents the largest source of aggregate federal receipts (Taxation, 2007). As such, attention will be focused solely on the effects of flat tax enactment for individuals at the federal level.

II. CURRENT TAX SYSTEM

In an effort to explain how moving toward a flat tax system would change the current tax environment in the United States, an explanation of the current tax system is in order. It is a reasonable assumption to make that many citizens do not truly understand how their income taxes are calculated. Individuals often outsource the preparation of their tax returns to paid-preparers, which means that they trust a third party to fill out the necessary forms and calculate their tax due. Others are more of the "do-it-yourself" type, but they typically use computer software programs that walk them through most of the leg work. The bottom line is that not everyone has a firm understanding of the current income tax system, and this portion of the paper serves to bring them up to speed.

Individuals must file a Form 1040 with the Internal Revenue Service each year in order to comply with the tax law. Form 1040 for the tax year 2011 is included in Appendix A on pages 34 and 35. Note that the form is more or less a two-page summary of numbers calculated in a variety of attached schedules. It is not uncommon for individuals' tax returns to be well over 50 pages in length. Having said all of this, the concept of calculating income taxes is not difficult. If one brings the income tax calculation down to its simplest terms, all that is in effect occurring is multiplying a number by a percentage (Korte, 2011). The complications arise when determining what the number should be and also which percentage(s) to use.

The most straightforward way to explain the current income tax system is to present the income tax formula and subsequently explain each variable. The formula more-or-less serves as a table-of-contents for the ensuing discussion and is presented below as Figure 1 (Bonsor):

Figure 1 Income Tax Formula
Gross Income **- Adjustments** **= Adjusted Gross Income (AGI)**
AGI **- Standard Deduction or Itemized Deductions** **- Exemptions** **= Taxable Income**
Taxable Income **x Tax Rate** **= Gross Tax Liability**
Gross Tax Liability **- Credits** **= Net Tax Due (or Refund)**

Gross income can be explained as all of the pre-tax dollars that a taxpayer earns, except for those items excluded by Congress. Specifically, gross income includes employment income, interest income, retirement income (pension and annuities), etc. (Bonsor). In the end, income will be taxed by a certain tax rate(s) in order to calculate the tax due; however, there are several modifications that will be made to gross income before the tax is calculated.

The tax code allows taxpayers to reduce their taxable income by "deducting" various items from gross income. Taxable income is the number found after netting income and deductions. Note that the first item in the income tax formula after gross income is adjustments. While the label of "adjustments" may sound confusing, an adjustment is nothing more than a deduction that is taken before other deductions are taken. Sample adjustments include student loan interest payments, moving expenses, any interest penalties that arise from withdrawing prematurely from a savings account, and alimony payments (Bonsor).

As mentioned, adjustments are nothing more than deductions, but they are placed on the tax return in a special location. A theoretical "line" is drawn in the process of calculating taxable income. This "line" is referred to as Adjusted Gross Income (AGI). Another name given to an adjustment is an "above-the-line deduction," which supports the assertion that adjustments are nothing more than deductions taken in a special part of the tax return. The tax code uses a person's AGI as a means of qualifying them for certain benefits and treatments (Bonsor). For example, a taxpayer's social security benefits may or may not be taxable depending upon whether or not his or her AGI[1] is more or less than the base amounts identified by the Internal Revenue Code (Service, 2011d).

After finding their AGI, taxpayers must subtract below-the-line deductions. There are two options from which they can choose. They can choose to take the standard deduction, or they can instead choose to itemize their deductions. The standard deduction is a specific amount

[1] Technically, the variable used to determine whether or not social security benefits are taxable is a taxpayer's *modified* AGI (Service, 2011d); however, this is beyond the scope of this paper.

that is determined by an individual's filing status. The various filing statuses include single, married filing jointly, qualifying widow(er), head of household, and married filing separately. Each filing status has a specific amount of standard deduction associated with it that can be deducted (Barrymore).

Instead of taking the standard deduction, an individual can choose to itemize his or her deductions. Itemizing deductions means specifically listing out certain deductible expenses in the tax return. Taxpayers can itemize a variety of different expenses, including charitable contributions, medical expenses, and state and local taxes. Various limitations and restrictions apply to certain deductions. For example, a taxpayer can only deduct medical expenses to the extent that the expenses exceed 7.5 percent of the taxpayer's AGI. So if a taxpayer had an AGI of $100,000, he or she would only be able to deduct medical expenses to the extent that they exceed $7,500. If medical expenses for the year were $8,000, only $500 would be deductible (Barrymore).

Whether to itemize or take the standard deduction is a common question for taxpayers. The best approach is to compare the individual's appropriate standard deduction to the total amount of itemized deductions he or she would be able to take. Whichever method produces the highest deduction amount should be chosen because the tax paid will be lowest for that choice. It is important to note that all taxpayers, regardless of whether they itemize or take the standard deduction, can take above-the-line deductions and use personal exemptions to reduce their taxable income (Barrymore).

In addition to adjustments and deductions, taxpayers can use exemptions to reduce their taxable income. Taxpayers can usually take a personal exemption for themselves. A second exemption can be taken for a spouse, and an additional exemption can be taken for each dependent of the taxpayer.

If someone else claims a taxpayer as a dependent, then that taxpayer may not take an exemption for himself or herself. For example, high school students often have jobs and file tax returns, but if their parents claim them as dependents, the students cannot take personal exemptions for themselves. There are various requirements that individuals must meet in order to claim someone else as a dependent, but these are beyond the scope of this paper. The main thing to take away from the discussion on exemptions is that in addition to adjustments and deductions, exemptions serve as an additional way to reduce taxable income (Service, 2011g).

For purposes of calculating the income tax due for the year 2011, the personal exemption amount is $3,700 per exemption. The $3,700 exemption amount is the same for each exemption, regardless of for whom the exemption is taken (Service, 2011a). For example, if a taxpayer is married and has three dependent children, then he or she can reduce taxable income by $18,500. The taxpayer would have one exemption for himself or herself, one for his or her spouse, and three for his or her dependent children. The $18,500 is calculated by simply multiplying five exemptions by $3,700 per exemption.

After subtracting adjustments, deductions, and personal exemptions from gross income, the remainder is taxable income. The next step is to multiply taxable income by the *appropriate* tax rate. Note the emphasis on "appropriate." The current tax system has marginal tax rates. This means that there are several different brackets, or rates, for various levels of income. Appendix B on page 36 displays the 2011 tax rate schedules published by the Internal Revenue Service. There are four different tables, and each table corresponds to one (or two) of the five filing statuses. Tax rates range from 10 percent to 35 percent, and the differences between the tables are primarily found in the income thresholds.

A common misconception about the bracket system is that all of a taxpayer's income is taxed at the rate corresponding to the marginal tax bracket in which he or she falls. For example, many people think that if a taxpayer's taxable income amount places him or her into the 25 percent tax bracket, then 25 percent of his or her taxable income will be paid in taxes. That is not the case. Each amount of income is taxed at the rate associated with it. Using the tax rate schedule for those with a filing status of single (Appendix B, page 36, Schedule X), a taxpayer with taxable income of $50,000 would pay $8,625 in taxes. This is calculated in Figure 2 below:

Figure 2
Income Tax Calculation

Calculation of Income Taxed	**Income Taxed**	**Rate**	**Tax**
$8,500.00 - $0.00	$8,500.00	10%	$850.00
$34,500.00 - $8,500.00	$26,000.00	15%	$3,900.00
$50,000.00 - $34,500.00	$15,500.00	25%	$3,875.00
Total	**$50,000.00**		**$8,625.00**

Note that the taxpayer fell into the 25 percent tax bracket, but $8,625 is not 25 percent of $50,000. It is instead closer to about 17 percent. In this example, the income from zero to $8,500 is taxed at 10 percent, the income from $8,501 to $34,500 is taxed at 15 percent, and the income from $34,501 to $50,000 is taxed at 25 percent. So while someone with higher levels of income will pay at higher rates, it does not mean that *all* of his or her income is taxed at those higher rates.

After calculating a taxpayer's gross tax liability, any tax credits must be subtracted in order to find the net tax due or refund owed. There are a variety of tax credits that individuals can take advantage of on their income tax returns. Some well-known credits include the earned income credit, the child and dependent care credit, the adoption credit, and the first-time homebuyer credit (Service, 2011h). The difference between credits and deductions is that credits reduce a taxpayer's tax liability dollar-for-dollar, where-as deductions only reduce the income that is taxed.

Looking back at the income tax formula at the beginning of this section, notice that deductions are taken before the tax is calculated; thus, deductions simply reduce the amount of income that is subject to tax. If a taxpayer has a $3,000 deduction, then $3,000 of his or her income will not be taxed. A $3,000 deduction does not mean that the taxpayer will get to pay $3,000 less in taxes. On the other hand, credits directly reduce the tax liability and are taken after taxable income is taxed at the appropriate rates. For example, if a taxpayer has a gross tax liability of $30,000 and a credit of $1,500, then his or her net tax due to the federal government would be $28,500.

This was only a brief outline and discussion on the current income tax system in the United States. The next section of this paper will detail how the tax system would function using a flat tax.

III. FLAT TAX SYSTEM

An early call for a federal flat tax in the United States was suggested in 1962 by Milton Friedman ("A Brief History of the Flat Tax," 1995). When Jerry Brown ran for President of the United States in 1992, he argued for a flat tax. Steve Forbes, who ran for President in both 1996 and 2000, also called for a flat tax to replace the current tax system (Skipper & Burton, 2008). Rick Perry and Herman Cain, two Republican candidates for the 2012 presidential election, had plans to change the current system to a flat tax system (Wood, 2011). Some states, including Indiana, Michigan, Pennsylvania, and Massachusetts, have implemented a flat rate for their own income taxes. According to an article entitled "The Spread of the Flat Tax in Eastern Europe," Estonia was the first country in Eastern Europe to adopt a flat tax. Several other Eastern European countries, such as Lithuania and Russia, went along with this idea by implementing their own versions of a flat tax (Evans & Aligica, 2008).

Before any arguments for or against the implementation of a flat tax commence, it would be prudent to explain how a flat income tax system might function in the United States. Since there is not currently a flat tax system in place, the ensuing discussion cannot be as matter-of-fact as the discussion on the current U.S. tax system. It will instead pull information and ideas from a variety of sources to provide a high-level picture of what the tax system might be like under a flat tax. Please keep in mind that this portion of the paper is focused on providing an unbiased explanation of how a flat tax would work and the differences between a flat tax and the current system. Arguments for and against it will be included in future sections.

Recall that the current income tax system has graduated rates; that is, different levels of income are taxed at different tax rates ranging from 10 percent to 35 percent. One major difference between the current tax system and a flat tax is that as the name implies, there would be one flat rate at which all income would be taxed. Various flat tax plans and proposals have been created, and consequently there have been a variety of proposed tax rates. Most of the plans propose having a flat tax rate of around 20 percent or less (Mitchell, 2005).

Another common provision of most flat tax proposals is that special preferences will no longer exist. The term "special preferences" refers to the various deductions, credits, and exemptions available to taxpayers under the current system. This means that there would be no standard deduction, as well as no itemized deductions for outflows like medical expenses and charitable contributions. Taxpayers would no longer be able to reduce their taxable income using traditional personal exemptions; however, some plans have one exemption based on family size. For example, a family with four members might in effect only have to pay tax on their income that is over $30,000 (Mitchell, 2005). With that being said, a plan with exemptions is not a true flat tax[2]. All tax credits, such as the Adoption Credit and the Residential Energy Credit, would also disappear.

Double taxation would be eliminated under a flat tax. Under most flat tax plans, the estate tax would disappear, and the taxes on portfolio income at the individual level would no longer exist. Individuals would only need to report the income that they earn from their labor, and they would not need to personally report portfolio income items (i.e. dividends). Currently, all of these types of income are brought together on the form 1040 and taxed at the individual level. Under a flat tax system, these business and capital income items would be taxed at the firm-level only (Mitchell, 2005).

Appendix C on page 37 shows what a flat tax form might look like for individuals and business entities (Mitchell, 2005). The first line on the form for individuals is where income from wages and pensions would be reported. The next several lines would calculate the individual's personal allowance, which is very similar to the concept of deducting personal exemptions in the current tax system. Whereas taxable income under the current system is

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[2] A true flat tax would be one where each dollar of income is taxed at exactly the same rate. If an exemption were present in the amount of $30,000, then the first $30,000 of income would essentially be taxed at a rate of zero percent; all income above $30,000 would be taxed at the prevailing flat rate.

calculated via the detailed tax formula that was focused on in Section II of this paper, taxable income under this version of a flat tax would simply be wages and pensions less total personal allowances. Taxable income is found on line six of this form, and line seven calculates the tax at a flat 17 percent rate. The tax due is reduced by the amount of tax that was already paid through withholdings, and the net tax due or refund due appears on line nine or ten respectively (Mitchell, 2005).

As mentioned earlier, Steve Forbes proposed doing away with the current income tax system and implementing a flat tax. He put together a comprehensive plan for a flat tax. Perhaps the most remarkable thing about his plan is that it would be optional; that is, those who favor the current tax system could opt to use it as they always have instead of switching to the flat tax system (Skipper & Burton, 2008).

The Forbes plan has many characteristics of the generic flat tax ideas mentioned earlier. He advocated a flat 17 percent tax rate. Many of the deductions present in the current system would be eliminated under his plan, but some of them would remain. One deduction that would remain would be personal exemptions for dependents. The exemption amount would be $4,000 per exemption, as opposed to the current system's 2011 exemption amount of $3,700. Tax credits that would remain in some form include the Child Tax Credit and the Earned Income Credit. A standard deduction would exist under the Forbes plan in the amounts shown in Figure 3 below (Skipper & Burton, 2008).

Figure 3
Standard Deductions – Forbes Plan

Single Individuals	$13,200
Heads of Households	$17,160
Married Couples	$26,400

As under the generic plan discussed earlier, the Forbes plan would tax portfolio income only at the business level and not at the individual level. Social security taxes would be completely abolished under his plan, along with the estate tax and the alternative minimum tax.

Now that the current income tax system and possible flat tax systems have been discussed, the following sections will present arguments both for and against implementing a flat tax system in place of the current system in the United States.

IV. ARGUMENTS IN FAVOR OF FLAT TAX IMPLEMENTATION

The following section serves to identify and explain several major arguments in favor of changing the current tax system to one based on a flat tax. Four significant topics of discussion are simplicity, fairness, economic impact, and international success.

Simplicity

The treasury secretary under President Nixon once said that America needed a tax system that looked "like someone designed it on purpose" (Economist, 2005). The current U.S. tax system is incredibly complex, and one of the more prominent reasons for changing over to a flat tax system is that the flat tax has a very simplistic approach to taxation. Under the current system, there are six different tax rates ranging from 10 percent to 35 percent, and different income thresholds correspond to each rate. To further complicate things, the income thresholds change depending on an individual's filing status. In addition to the various rates that apply to ordinary income, different rates apply to unearned income items such as capital gains. For example, the current tax system taxes capital gains at a rate of either zero percent (no tax) or 15 percent[3] depending on the amount of income reported. A flat tax would implement a single marginal tax rate, such as 20 percent, on all taxable income for each taxpayer regardless of filing status or income level (Taxation, 1995).

Another way that having only one tax rate would simplify the tax arena has to do with reducing administrative headaches for both businesses and the federal government. Currently, income tax must be withheld from taxpayer paychecks. The amount of income withheld is based on employee wage levels, personal and dependency exemptions, etc. Employees must submit the Form W-4, which provides their employers with the information necessary to withhold the proper amount from every paycheck. This form should be filled out each year that an employee's tax situation changes, such as when a new child is born and another dependency exemption is therefore allowed (Service, 2011f). Employers must spend time and resources withholding the appropriate amount from each of their employees' paychecks, and the IRS must make sure that each individual employee is withholding and paying the correct amount of tax.[4]

Due to the fact that every dollar of income is taxed at one rate under a flat tax system, the IRS theoretically should be indifferent to the amount of income that each taxpayer receives. If the flat tax rate is 17 percent, then each employer could potentially just remit 17 percent of its payroll expense to the government. According to an article published by *The Economist* in 2005, "the tax collector [currently] needs to tax the wage packets of 130m or more employees, rather than simply taxing the payrolls of 8m or so enterprises" (Economist, 2005). The IRS could potentially only need to worry about collecting tax from each business instead of each wage-

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[3] Note that only *long-term* capital gains are taxed at these preferential rates, and specific rates apply to collectibles (28 percent) and un-recaptured Section 1250 gain (25 percent) (Eugene Willis, 2010).

[4] While the IRS is technically responsible for making sure that all taxpayers calculate and pay the correct amount of tax, it does not actually check each taxpayer's return. Instead, the IRS relies upon various rating systems to identify high-risk returns that should be audited.

earner, which should greatly reduce its oversight costs. It should also reduce costs for employers because they would no longer need to withhold unique amounts for each employee and could instead withhold a percentage of their total payroll expense.

Not only would simplification arise from having a single tax rate, but it would also come from changing the types of income that are included in the tax base. For example, the current system taxes the interest income from federal and corporate bonds, but the interest income from state and local bonds is tax-free. Taxpayers must separately report these various types of income on their tax return. Those that have significant wealth invested in these investments must also keep detailed records differentiating between the two types of investments and the income attributable to them. Many flat tax plans propose having all interest income excluded from the tax base, which means that individuals would not need to worry about reporting it or keeping special records (Taxation, 1995).

A flat tax system would further simplify the tax process by eliminating the option to itemize deductions and take credits. Currently, individuals can deduct a variety of expenses on their tax returns. Charitable contributions, property taxes paid, mortgage interest paid, and state and local income taxes paid are the deductions most commonly seen on returns. Other common deductions include medical expenses, moving expenses, and investment interest expenses. While these deductions may seem to be advantageous for taxpayers, it may also cause them significant headaches. An immense amount of recordkeeping and administrative work unfortunately goes along with deducting these items (Taxation, 1995). For example, taxpayers must obtain and retain documentation to support any charitable contributions that they elect to deduct. The IRS Web site states that:

> "For a contribution of cash, check, or other monetary gift (regardless of amount), you must maintain as a record of the contribution a bank record or a written communication from the qualified organization containing the name of the organization, the date of the contribution, and the amount of the contribution" (Service, 2011i).

There are documentation requirements for other itemized deductions as well. Having to faithfully keep documentation for itemized deductions simply adds another layer of complexity and frustration to the present tax code. With the abolishment of itemized deductions under a flat tax system, this issue would no longer exist.

One of the great benefits that arises from having a simplified form of income taxation is that compliance costs would be drastically reduced if not eliminated altogether. The Heritage Foundation published an article claiming that each year taxpayers pay more than $100 billion in tax return preparation (Mitchell, 2005). This figure is made up of the amounts paid to accountants, lawyers, and other paid-preparers. It also includes the cost of various tax compliance software programs, such as TurboTax. The IRS brought forth the statistic that taxpayers spend 6.6 billion hours each year on filing their taxes, and 1.6 billion of those hours are specifically related to filing the Form 1040. The opportunity cost associated with 6.6 billion hours is certainly a noteworthy item to consider. On an individual level, the IRS suggests that it should take "an estimated 26 hours and 48 minutes to prepare the Form 1040 and its most common supporting schedules." That number includes the time devoted to maintaining records, understanding the tax law, and actually preparing and mailing in the forms (Press, 2005).

These numbers sound outrageous; however, when one considers that in 2005 there were 893 different tax forms in existence, they become quite believable (Mitchell, 2005). Most flat tax plans propose requiring taxpayers to only fill out a post-card sized form in place of the multiple page Form 1040 that they file currently. Needless to say, the associated compliance costs would be dramatically reduced. Also, research shows that more people would comply with the law and report a greater percentage of their income under a more simple system. Before Russia implemented its flat tax in 2001, it was estimated that taxpayers only reported 52 percent of their income; after a flat tax rate was put into place, the Russian government estimated that the same taxpayers reported 68 percent of their income (Economist, 2005).

Fairness

Fairness of the tax code has been a source of debate since its origin. Consider two taxpayers that had the exact same amount of gross income during the tax year; however, Taxpayer A has a much lower tax liability than Taxpayer B. This of course must be due to the nature and amount of the deductions and credits taken by each of them. Suppose that Taxpayer A had a large amount of medical expenses that were deducted against his income, and that is the reason why his tax liability is so much less than Taxpayer B's (Taxation, 1995). Some would argue that Taxpayer A should not get to pay less in taxes simply because he had more medical bills than Taxpayer B, especially if the medical bills were a direct result of poor life decisions (i.e. fighting lung cancer that was caused by smoking). Of course, a situation's fairness is nothing more than an opinion, but a flat tax would make this concern null and void because medical expenses, as well as all other itemized deductions, would not be deductible for anyone.

In addition to the debate over fairness among those with equal levels of income discussed above, fairness among those with different levels of income must be considered. As was previously stated, the current tax system has a progressive rate structure where higher levels of income are taxed at higher rates. Many argue that it is not fair for one taxpayer to be taxed at an effective rate of 17 percent when another taxpayer with lower income is taxed at a 10 percent effective rate. Similar to the previous discussion about fairness among equals, the fairness of this situation would be nothing more than an opinion. The fact of the matter remains, however, that the current system is progressive, and a flat tax system would treat all taxpayers the same.

An article from the *Wall Street Journal* published in 2011 mentioned that "the percentage of U.S. households paying no federal income tax has been climbing, and reached 51% for 2009, according to a new analysis by the Joint Committee on Taxation." Of the 49 percent of taxpayers who actually paid federal income tax, 30 percent of them received money from the federal government via tax credits (McKinnon, 2011). Statistics like these often lead higher wage earners to call for an overhaul of the tax system, and specifically for a flat tax of some kind. They feel as though the tax burden should be felt by everyone and that a flat tax on everyone's income would be the most efficient way to do it.

It is not only higher wage earners who would prefer having a flat tax, but also lower and middle-income taxpayers. Many think that wealthy Americans and businesses actually receive too many tax breaks from the government. In an article published by the Cato Institute, author Daniel J. Mitchel expressed that "[...] there would have been no tax preferences. Lawmakers no longer would have been able to swap loopholes for campaign cash." Since most flat tax plans have no special deductions or credits, switching to such a plan might indeed reduce the amount of political corruption that is currently present in Washington. It would essentially level the playing field for all taxpayers (Mitchell, 2007).

Economic Impact

The current tax system is progressive, which means that higher levels of income are taxed at higher rates. Aside from the ever-present arguments regarding the fairness of such a system, it has definite effects on the economy. Most individual taxpayers operate under the cash receipts and disbursements method of accounting, which is more commonly known as the "cash method." Under this system, income is recognized when cash is received[5] and expenses are deducted when cash is paid (Service, 2011c). Taxpayers can realize significant tax-savings if they carefully plan when they receive and pay cash. For example, suppose that a taxpayer is due to receive a $50,000 payment for services provided. He or she must report that income when the cash is received. If the taxpayer is already having an exceptional year and is in the 35 percent tax bracket, receiving that extra $50,000 may not be ideal. It would instead be more advantageous to delay receipt, where possible, of that income to the next year when he or she might be in a lower bracket.

While the ability to have some discretion as to when income and deductions are reported may seem like a positive aspect of the current system, it can involve a significant amount of planning. Planning takes time and resources. Taxpayers must either spend their own time determining how best to manage their cash receipts and disbursements, or they must pay for tax advice from a professional, such as a certified public accountant. Regardless of which method is chosen, resources that could otherwise be put to more productive uses are expended on complying with the tax law (Taxation, 1995). A flat tax system would have only one rate, which means that there would be no need for this tax planning. Fifty thousand dollars received during a year with already high levels of income would be taxed exactly the same as if it were received during a year with low levels of income.

Going along with the concept of money and capital not going to the most productive uses in society, the tax effects on investments must be discussed. First, consider income from

[5] Note that under the cash method, income is technically recognized when cash is received or *constructively received*. Taxpayers have constructively received income when the amount of income is made available to them without restriction (Service, 2011c).

investments in corporate securities. Investing in a corporation's stock is common practice for many individuals because stocks can generate current income through the issuance of dividends. Corporate dividends are a classic example of income that is "double taxed." Double taxation means that income is taxed at two levels. Dividends are essentially a distribution of a corporation's earnings to its owners or stockholders. Corporations must pay taxes on their income just like individuals. A corporation's income is taxed before it distributes a dividend, and then the dividend income is taxed again at the individual level. The extra tax dollars lost from double taxation could have been invested in more productive areas of the economy.

Next, consider an investment in state and local bonds. Interest from state and local bonds is tax-free. This provides incentive for investment in these types of entities, which on their own might not have the ability to pay yields that are competitive with corporations. Especially when compared to corporate dividends that are essentially taxed twice, state and local bonds may be quite attractive to investors. Investors might invest in these securities purely for the tax benefits. A publication by the Joint Committee on Taxation comments that the "efficiency of the capital market in allocating capital to its most highly valued uses" may be reduced because the favorable tax treatment of investments like state and local bonds "distort[s] investor decisions" (Taxation, 1995). Many flat tax proposals suggest having portfolio income, such as dividends, taxed only at the business level. Individual investors would not need to report dividend income on their personal income tax returns, which could potentially eliminate the market efficiency distortion.

International Success

According to an article published by the *Cato Policy Report* in 2007, "The flat tax has never made it through Congress, but it has been adopted by more than a dozen other countries since 1994." The table in Appendix D on page 38 is from that article and lists each country, the year that it enacted a flat tax, and its flat tax rate as of 2007 (Mitchell, 2007). Notice from the table that flat tax systems are more prevalent among Eastern European nations. Estonia and Lithuania were two of the earlier European nations to adopt one.

In 1994, Estonia implemented a tax system using a 26 percent flat tax rate and a modest personal exemption. It was the original Eastern European country to create such a tax system. Estonia's economy responded favorably and grew significantly. After the flat tax was adopted in 1994, it experienced a growth rate that reached a double-digit peak in 1997. Since then, it has seen a steady growth rate of approximately 6 percent (Economist, 2005). Lithuania has experienced similar success with its system of a single 33 percent tax rate and a personal exemption. Its economy has grown at rates of 6.7 percent in 2002, 9 percent in 2003, and 8 percent in 2004 (Skipper & Burton, 2008).

When looking at the table in Appendix D, one might notice that some of the flat tax rates appear to be rather high. Consider, however, that Estonia's rate started in 1994 at 26 percent and as of 2007 had decreased to 22 percent (Mitchell, 2007). According to the Estonian Tax and Customs Board Web site, the tax rate dropped to 21 percent in 2008, and it has remained constant since then (Board, 2010). Going from a tax rate of 26 percent in 2004, which was the last year that the original 26 percent rate was in effect, to 21 percent in 2008 is an approximate 19 percent decrease in the tax rate. Lithuania initiated its flat tax at a rate of 33 percent and by 2007 had already reduced it by six percentage points to 27 percent (Mitchell, 2007). There clearly seems to be a downward trend in flat tax rates.

One of the main concerns about switching to a new tax system is whether or not the country will be able to raise at least the same amount of revenue that it is currently generating.

Based on the results of the flat tax in Estonia, however, it seems that a flat tax will indeed raise as much revenue. In 1993, which is one year before the flat tax was implemented in Estonia, revenues collected by the government were equal to approximately 39.4 percent of the country's gross domestic product (GDP). By 2002, government revenues had climbed to 39.6 percent of GDP (Economist, 2005).

There are a variety of arguments supporting the position that the United States should do away with its current tax system and replace it with a flat tax. Supporters argue that a flat tax would bring considerable simplicity to what is at this time a very involved and convoluted process. It would also make things fairer for all classes of Americans, wealthy and lower wage earners alike. The success of flat tax systems abroad in countries like Estonia and Lithuania shows that the economic impact of a flat tax would most likely be positive.

V. ARGUMENTS AGAINST FLAT TAX IMPLEMENTATION

The following section discusses arguments against flat tax implementation in the United States. Four areas of focus include transition issues, the loss of deductions and credits, the government's loss of influence, and fairness.

Transition Issues

The income tax system in the United States has been in place for almost 100 years. It has been altered multiple times and is continually evolving with the most recent major overhaul occurring in 1986 under President Reagan (Bonsor). With that being said, there has never been a complete change in the tax code as drastic as there would be if a flat tax were adopted. Switching to a flat system would require the current system to be scrapped completely. Transition issues would arise administratively from the IRS's perspective as it would need to implement new methods for overseeing the tax collection process. An even more important transition issue would arise from what William Gale calls "old capital" in his article "Flat Tax," which was published by the Brookings Institution.

Old capital refers to assets accumulated under the current tax system (prior to a tax change). Take for example an Individual Retirement Account (commonly referred to as an IRA). With a traditional IRA, workers can contribute money to an investment vehicle and subsequently deduct the contribution on their tax return. The contributions accumulate and grow both from tax-deferred investment returns and from additional contributions made by the worker. Contributions and investment earnings are then taxed as ordinary income upon withdrawal by the worker (Rejda, 2008).

The tax advantages from this investment vehicle come not only from the deduction allowed for contributions and the tax-deferred investment earnings, but from the fact that the worker will usually be in a lower tax bracket at the time of withdrawal. Consider a worker whose IRA has grown over the course of his life. During most of his career, he was in the 33 percent tax bracket, and at retirement, he is in the 15 percent bracket. Any withdrawals that he makes from the IRA will be taxed as ordinary income. Considerable savings arise because all of the income from the IRA avoids being taxed at the 33 percent marginal rate and is instead taxed at a top marginal rate of 15 percent.

Under a flat tax, theoretically all income is subject to being taxed at the flat rate. Continuing with the above example, transition issues might arise if the flat rate is greater than 15 percent. Suppose the flat rate is 20 percent. The taxpayer was counting on his withdrawals being taxed at a maximum of 15 percent, but since the flat tax has been enacted, they will instead be taxed at 20 percent. This could be a considerable point of contention and brings up the prime issue regarding transition: what happens to taxpayers who made decisions years ago that were advantageous mainly because of the way the tax system was structured? These are questions that anyone advocating for such a major tax code overhaul would need to answer.

One potential solution to this issue and to similar problems could be to enact a grandfather clause which would exempt from the new system's changes those taxpayers who made decisions assuming that the current tax system rules would stay in effect. Other possible solutions could be to allot certain exemptions or tax credits to those who are significantly affected by the switch. Collectively, these solutions are sometimes referred to as transition rules, and they have been enacted in the past when a change in the tax code proved to be inequitable for certain people ("Understanding the Tax Reform Debate: Background, Criteria, and Questions: GAO-05-1009S," 2005). In his article entitled "Transition Issues: A Tax Lawyer's Perspective," Ronald A. Pearlman stated that Congress made these exceptions based on the "reliance claim," which is the idea "that it is unfair to change a tax rule after a taxpayer acted because of that rule" (Pearlman, 1996).

To illustrate this in his paper, Pearlman discussed the low-income housing credit. This credit is provided to a taxpayer for 10 years after he or she completes a qualified building project. There were numerous individuals who built houses exclusively because this credit existed. If Congress were to repeal the credit, those taxpayers who had not yet received their full 10 years of credits could reasonably be allotted some type of exemption or relief from the repeal (Pearlman, 1996). The earlier discussion on IRAs is easily related to this in that the taxpayer might have invested in a traditional IRA solely because he or she wanted to take advantage of lower tax rates at the time of withdrawal. A taxpayer faced with a flat tax rate at retirement that is higher than the lower tax rate would have been under the current system could reasonably demand some form of relief.

With all of this being said, special rules and exceptions, warranted though they may be, are what made the current system the haphazard jumble that it is today. Allowing such items to be written into the new tax code would detract from simplicity, which is one of the principal arguments for enacting a flat tax. Supporters of the flat tax contend that its simplicity and success in Eastern European countries should speak volumes about its potential for success in the United States; however, none of these countries enacted a flat tax after scrapping a tax system that had been in place and reasonably well-functioning for multiple decades. Also, Daniel Mitchell of the Cato Institute made the point that since the U.S. economy is already quite wealthy, "it is very unlikely that a flat tax would generate the stupendous annual growth rates enjoyed by [Eastern European] nations" (Mitchell, 2007).

Taxpayers have made significant decisions in their lives counting on the current structure of the tax code to remain in place. It is one thing to change certain details about the code, and in fact, these changes occur seemingly under each new presidential administration. It is entirely different to completely discard the current code and enact a new concept. Transition issues would most definitely arise and should be diligently considered.

Loss of Deductions and Credits

Most flat tax plans do not allow taxpayers to reduce their taxable income through the use of deductions and credits. As explained in an earlier section of this paper, the current tax system calculates a taxpayer's tax liability by applying the applicable rate(s) to the number that results from netting income with deductions. The tax liability is then reduced dollar-for-dollar by any applicable credits. Even though deductions and credits greatly add to the complexity of the current system, in actuality they are one of the system's principal advantages. Deductions and credits reduce taxpayers' liabilities. Under a generic flat tax plan, these deductions and credits do not exist, and taxpayers are subject to direct taxation. There is in essence no buffer between their income and the calculation of tax.

One of the most popular deductions taken by taxpayers is the mortgage interest deduction. This deduction is a major advantage of home ownership and in its absence, taxpayers would have a reduced ability to pay their mortgages (Rothbard). If one looks at this from a high-level view, wiping out the mortgage interest deduction in effect increases the cost of owning a home. Similar to the previously mentioned "old capital" discussion, purchasing a home is a long-term decision that taxpayers make, and the decision to buy is made assuming that interest payments are and will remain deductible.

The increased cost would exacerbate the current foreclosure crisis and force taxpayers to make sacrifices in other areas of their lives to avoid defaulting on their payments, or it might even force them to sell and downsize into a smaller home. For those who are looking to purchase a new home, the increased cost of ownership might limit their choices to smaller, less expensive homes. Looking at this from a different perspective, a taxpayer's after-tax return on his or her house would decline because the effective purchase price of the investment would increase (Rothbard). An overall decrease in taxpayers' standard of living could result.

Another extremely popular method of reducing taxable income is the deduction for charitable contributions. Currently, taxpayers are allowed to deduct contributions made to "organizations that are religious, charitable, educational, scientific, or literary in purpose" (Service, 2010). From an altruistic perspective, one would like to think that people donate money to charities for the pure purpose of helping others. While that may be true in some cases, one cannot discount the incentive to donate that arises because of the charitable contribution deduction.

The charitable contribution deduction in essence makes donating less expensive for taxpayers. A one dollar donation to charity results in a one dollar deduction, which means that one dollar of income avoids being taxed. Assuming a tax rate of 35 percent, the tax saved on that one dollar of income is 35 cents; therefore, for every dollar donated to charity, the true cost to the donor is only 65 cents. Depending on the vantage point one takes, the charitable contribution deduction either allows taxpayers to donate more than they normally would have, or it allows them to donate and still have enough money left for other activities.

It is quite plausible that if a flat tax were implemented and the charitable contribution deduction were subsequently eliminated, then the amount of cash and property donated to charities would dramatically decrease. In an article published by the Mises Institute, Murray Rothbard argued that a flat tax could result in a "drastic crippling of private charitable and educational organizations." He suggests that these organizations might instead turn to the federal government for funding, which means that all taxpayers would share in the burden (Rothbard). If the underfunded charities did not (or were unable to) seek help directly from the federal government, then the people once supported by the charities would themselves turn to the government for help. Either way, this would only further increase the welfare state run by the federal government.

In addition to the deductions for mortgage interest and charitable contributions, taxpayers can currently deduct medical and dental expenses in excess of 7.5 percent of their AGI. Also, a deduction exists for part or all of the losses incurred from casualty or theft[6] (Service, 2010).

[6] Personal casualty or theft losses are deductible only if they are greater than $100 and to the extent that they exceed 10 percent of the taxpayer's AGI (Service, 2010).

These two deductions are excellent examples of ways in which the current tax code serves to aid those who undergo some form of hardship during the year by helping to reduce some of the cost of their burden(s). The removal of these deductions, should a flat tax system be enacted, will only cause additional harm to those already facing hard times.

Tax credits would also be a thing of the past should a flat tax system replace the current system. One such credit that would disappear is the Child and Dependent Care Credit, which enables taxpayers to reduce their tax liability by a certain amount that is related to costs paid for childcare during the tax year (Service, 2011b). The Residential Energy Credit, which allows taxpayers to take a credit if they made energy saving improvements to their homes, would also disappear.

Government's Loss of Influence

There is generally one of two reasons behind the creation of a deduction or credit. The federal government either wanted (1) to give taxpayers relief should they be facing difficult times (i.e. the deduction for casualty and theft losses), or (2) to influence taxpayer behavior. As mentioned in the previous section, the tax code allows the federal government to efficiently influence the choices that taxpayers make and the exchanges in which they engage. For example, the federal government is dedicated to reducing America's environmental footprint, and it subsequently created the Residential Energy Credit so that taxpayers would have an incentive to purchase energy efficient windows, doors, etc. for their homes.

Keep in mind that it is not only credits that the federal government uses to influence behaviors, but also deductions. The government encourages taxpayers to become homeowners by allowing the mortgage interest deduction. It also wants to support charitable organizations and prudently allows for the charitable contributions deduction. The tax code looks the way it does today expressly because of the way the federal government uses it as a tool to drive consumer behavior. The Joint Committee on Taxation mentioned in a publication that many of the complicated items in the present tax code exist as a "result of Congressional decisions to pursue other policy goals." It specifically mentioned an example regarding the research and experimentation tax credit, which was created for the sole purpose of incentivizing taxpayers to increase their research endeavors (Taxation, 1995). Converting to a flat tax system would eliminate this method of influencing taxpayers.

Some might argue that the federal government having less control is a good thing; however, at least with the present tax code, the government incentivizes its citizens to *choose* certain actions. Without such a tool, perhaps it would resort to more direct measures, such as mandates, which is most likely not something the majority of citizens would prefer.

Fairness

Studies have also shown that upon implementation of a flat tax system, the rich would receive an enormous tax cut, and the poor and middle classes would end up paying more in taxes. The rich do not spend all of their wealth, and they subsequently invest it in stocks, bonds, real property, etc. Under most flat tax plans, the individual tax on portfolio income is eliminated, which means that the rich would receive a vast amount of their income tax-free. Warren Buffet had a taxable income of approximately 40 million dollars in 2010, and he paid close to seven million dollars of that in taxes. Qualified dividends and capital gains are taxed at a rate of 15 percent, and any ordinary income (i.e. wages) above $379,150 for married filing jointly taxpayers is taxed at 35 percent. Buffet's effective tax rate was 17.4 percent. This indicates that the vast majority of his income came from dividends and capital gains because his effective rate is much closer to the 15 percent qualified dividend / capital gain rate than it is to the 35 percent rate for ordinary income (Sahadi, 2011).

Many people were outraged that the current tax system allowed someone as wealthy as Warren Buffet to pay so little in taxes, and they are not necessarily out of line for feeling this way. Under a flat tax system, however, since the focus is usually on taxing earned income (not portfolio income), people like Warren Buffet would pay significantly less. In fact, most of his income would come to him tax free.

Figure 4 below lists the average effective federal income tax rates for the tax year 2009 (Logan, 2011). Notice from the data that the average tax rate for all taxpayers was 11.06 percent, and the average tax rate for the top one percent was 24.01 percent. Also note that the next highest tax rate was 16.40 percent; all other classes paid at lower rates. If a pure flat tax were implemented with a flat rate of 17 percent, which is the rate that Steve Forbes suggested (Skipper & Burton, 2008), then the top one percent of wage earners would see a huge tax decrease (24.01 percent down to 17 percent). The other 99 percent would see tax increases. Some of the tax increases would be phenomenal in amount. For instance, the bottom 50 percent would see an 819 percent increase in their tax rate!

Figure 4

Summary of Federal Income Tax Data, 2009

	Average Tax Rate
All Taxpayers	11.06%
Top 1%	24.01%
1-5%	16.40%
5-10%	11.40%
10-25%	8.23%
25-50%	5.58%
Bottom 50%	1.85%

If 99 percent of taxpayers would see a tax increase[7] under a flat tax system, then one must wonder why the flat tax has so much support behind it. Perhaps the naivety of the average taxpayer when it comes to the calculation of his or her tax liability is the reason why so many support a flat tax. For example, a single taxpayer in the 25 percent tax bracket might incorrectly assume that all of his or her income is taxed at 25 percent. A flat tax of 17 percent may sound like a significant improvement; however, in reality only the income over $34,500 is taxed at 25 percent. The first $8,500 of income are taxed at 10 percent, and the income from $8,501 to $34,500 is taxed at 15 percent (Service, 2011a). A single taxpayer with a taxable income of $45,000 would pay $7,375 in tax, which would result in an effective tax rate of approximately 16.4 percent. A flat rate of 17 percent would actually increase his or her tax liability. In addition, the loss of deductions and credits under a flat tax would increase the amount of income subject to tax; therefore, a higher rate would be applied to a larger tax base.

Many arguments exist supporting the notion that the United States should not change to a flat tax system. Transition issues would definitely appear, and the loss of deductions and credits could prove to be devastating for individuals. The federal government would lose an effective tool of influence, and most Americans would see a tax increase.

VI. CONCLUSION

One of the most popular arguments in favor of a flat tax is that it would be much fairer than the current system. On the other hand, one of the main arguments against implementing a flat tax is that the current system is fairer than a flat system would be. Both sides of the debate present fairness as an argument, but what exactly constitutes fairness? Some might say that

[7] Note that this is true if the flat tax rate is 17 percent. There is no guarantee that the plan adopted would have a 17 percent rate.

fairness with respect to taxation means that all taxpayers, regardless of income level, should pay the same proportion of their income in taxes. This means that assuming a 17 percent flat rate, the taxpayer making over one million dollars a year and the taxpayer making less than ten thousand dollars a year would both pay 17 percent of their income in taxes. Others might suggest that the same rate of tax should be applied to all of those taxpayers who are in *similar financial situations* (Taxation, 1995). The issue with this viewpoint, however, is there is no clear definition as to what constitutes being similarly situated.

Is a taxpayer with large sums of medical expenses in a similar financial situation to another taxpayer who has the same amount of income but no medical expenses? Suppose there are two taxpayers earning the same amount of income, but one of them contributes ten times more of his or her earnings to charities than the other. Are they considered to be in the same financial situation? Consider the two individuals discussed in the previous paragraph. One of them generates one million dollars of income in a year, and the other generates less than ten thousand dollars. Are these taxpayers in a financial situation similar enough to pay the same proportion of their income in taxes? There are many different opinions regarding what is "fair," and this represents the main reason why tax policy is such a heavily debated topic.

Fairness of the tax system aside, a pure flat tax would never survive in the United States as a legitimate method of taxation. A pure flat tax system is one where every American's income is taxed at exactly the same percentage regardless of their income amount. As discussed in Section V of this paper, 99 percent of Americans would most likely see a tax increase under such a plan (depending on the rate that is enacted). Any politician that proposes and tries to enact such a plan would essentially be committing political suicide. With that being said, most flat tax proposals are not truly "flat." They are hybrids and usually have some level of progressivity to them by way of an exemption amount.

It is not necessary to have progressive tax rates in order to have a progressive tax system. Suppose that a flat tax plan has a 20 percent rate and a 30,000 dollar exemption. This means that for the first $30,000 of income, the tax rate is zero percent, and any income over $30,000 is then taxed at the 20 percent rate. Twenty percent is the official tax rate, but the effective rate would vary depending on the income level (Taxation, 1995). Even under a so-called "flat" system with a single marginal rate, the effective tax rate could be anything but flat. It all depends on the plan at hand.

In the pool of GOP candidates for the 2012 presidential election, at least two candidates have advocated flat taxes. Herman Cain has tried his best to sell the American people on his "9-9-9 Plan," which includes a nine percent flat tax on individual income. Rick Perry has rolled out a flat tax plan with a 20 percent rate and the option to choose whether to use the current system or a new flat system. Neither one of their plans is a pure flat tax, however, because they both allow some form of an exemption amount (Elliott, 2011; Wood, 2011).

In conclusion, a pure flat tax is definitely not the best substitute for the current system. With that being said, to make a blanket statement declaring that a hybrid flat tax plan is a terrible idea or that it would be a huge improvement over the reasonably well-functioning current system would be a disservice to the reader. Each potential change in the tax code must be evaluated on its own merits because all plans are different and the issues at stake are not black and white. The current system is not perfect by any means, and there is always room for improvement.

APPENDIX A

2011 Form 1040: U.S. Individual Income Tax Return (Service, 2011e)

Form **1040** Department of the Treasury - Internal Revenue Service (99) **U.S. Individual Income Tax Return** **2011** OMB No. 1545-0074 IRS Use Only - Do not write or staple in this space.

For the year Jan. 1-Dec. 31, 2011, or other tax year beginning , 2011, ending , 20 — See separate instructions.

Your first name and initial	Last name	**Your social security number**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions. Apt. no.		▲ Make sure the SSN(s) above and on line 6c are correct.
City, town or post office, state, and ZIP code. If you have a foreign address, also complete spaces below (see instructions).		**Presidential Election Campaign**
Foreign country name	Foreign province/county / Foreign postal code	Check here if you, or your spouse if filing jointly, want $3 to go to this fund. Checking a box below will not change your tax or refund. ☐ You ☐ Spouse

Filing Status

Check only one box.

1 ☐ Single
2 ☐ Married filing jointly (even if only one had income)
3 ☐ **Married filing separately.** Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See instructions.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child

Exemptions

6a ☐ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☐ **Spouse**
c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if child under age 17 qualifying for child tax credit (see instructions)
			☐
			☐
			☐
			☐

If more than four dependents, see instructions and check here ▶ ☐

d Total number of exemptions claimed

Boxes checked on 6a and 6b
No. of children on 6c who:
• **lived with you**
• **did not live with you due to divorce or separation (see instructions)**
Dependents on 6c not entered above
Add numbers on lines above ▶

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see instructions.

Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**

7	Wages, salaries, tips, etc. Attach Form(s) W-2		7
8a	**Taxable** interest. Attach Schedule B if required		8a
b	**Tax-exempt** interest. **Do not** include on line 8a	8b	
9a	Ordinary dividends. Attach Schedule B if required		9a
b	Qualified dividends	9b	
10	Taxable refunds, credits, or offsets of state and local income taxes		10
11	Alimony received		11
12	Business income or (loss). Attach Schedule C or C-EZ		12
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		13
14	Other gains or (losses). Attach Form 4797		14
15a	IRA distributions	15a	b Taxable amount 15b
16a	Pensions and annuities	16a	b Taxable amount 16b
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		17
18	Farm income or (loss). Attach Schedule F		18
19	Unemployment compensation		19
20a	Social security benefits	20a	b Taxable amount 20b
21	Other income. List type and amount		21
22	Combine the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		22

Adjusted Gross Income

23	Educator expenses	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889	25	
26	Moving expenses. Attach Form 3903	26	
27	Deductible part of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid b Recipient's SSN ▶	31a	
32	IRA deduction	32	
33	Student loan interest deduction	33	
34	Tuition and fees. Attach Form 8917	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 35		36
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		37

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see separate instructions. Cat. No. 11320B Form **1040** (2011)

Tax and Credits

38	Amount from line 37 (adjusted gross income)			38	
39a	Check if: ☐ You were born before January 2, 1947, ☐ Blind. ☐ Spouse was born before January 2, 1947, ☐ Blind. Total boxes checked ▶ 39a				
b	If your spouse itemizes on a separate return or you were a dual-status alien, check here ▶ 39b☐				
40	**Itemized deductions** (from Schedule A) **or** your **standard deduction** (see left margin)			40	
41	Subtract line 40 from line 38			41	
42	**Exemptions.** Multiply $3,700 by the number on line 6d			42	
43	**Taxable income.** Subtract line 42 from line 41. If line 42 is more than line 41, enter -0-			43	
44	**Tax** (see instructions). Check if any from: **a** ☐ Form(s) 8814 **b** ☐ Form 4972 **c** ☐ 962 election			44	
45	**Alternative minimum tax** (see instructions). Attach Form 6251			45	
46	Add lines 44 and 45 ▶			46	
47	Foreign tax credit. Attach Form 1116 if required	47			
48	Credit for child and dependent care expenses. Attach Form 2441	48			
49	Education credits from Form 8863, line 23	49			
50	Retirement savings contributions credit. Attach Form 8880	50			
51	Child tax credit (see instructions)	51			
52	Residential energy credits. Attach Form 5695	52			
53	Other credits from Form: **a** ☐ 3800 **b** ☐ 8801 **c** ☐	53			
54	Add lines 47 through 53. These are your **total credits**			54	
55	Subtract line 54 from line 46. If line 54 is more than line 46, enter -0- ▶			55	

Standard Deduction for –
- People who check any box on line 39a or 39b **or** who can be claimed as a dependent, see instructions.
- All others:

Single or Married filing separately, $5,800

Married filing jointly or Qualifying widow(er), $11,600

Head of household, $8,500

Other Taxes

56	Self-employment tax. Attach Schedule SE	56	
57	Unreported social security and Medicare tax from Form: **a** ☐ 4137 **b** ☐ 8919	57	
58	Additional tax on IRAs, other qualified retirement plans, etc. Attach Form 5329 if required	58	
59a	Household employment taxes from Schedule H	59a	
b	First-time homebuyer credit repayment. Attach Form 5405 if required	59b	
60	Other taxes. Enter code(s) from instructions	60	
61	Add lines 55 through 60. This is your **total tax** ▶	61	

Payments

62	Federal income tax withheld from Forms W-2 and 1099	62			
63	2011 estimated tax payments and amount applied from 2010 return	63			
64a	**Earned income credit (EIC)**	64a			
b	Nontaxable combat pay election 64b				
65	Additional child tax credit. Attach Form 8812	65			
66	American opportunity credit from Form 8863, line 14	66			
67	First-time homebuyer credit from Form 5405, line 10	67			
68	Amount paid with request for extension to file	68			
69	Excess social security and tier 1 RRTA tax withheld	69			
70	Credit for federal tax on fuels. Attach Form 4136	70			
71	Credits from Form: **a** ☐ 2439 **b** ☐ 8839 **c** ☐ 8801 **d** ☐ 8885	71			
72	Add lines 62, 63, 64a, and 65 through 71. These are your **total payments** ▶			72	

If you have a qualifying child, attach Schedule EIC.

Refund

73	If line 72 is more than line 61, subtract line 61 from line 72. This is the amount you **overpaid**	73	
74a	Amount of line 73 you want **refunded to you.** If Form 8888 is attached, check here ▶☐	74a	
▶ b	Routing number ▶ c Type: ☐ Checking ☐ Savings		
▶ d	Account number		
75	Amount of line 73 you want **applied to your 2012 estimated tax** ▶ 75		

Direct deposit? See instructions.

Amount You Owe

76	**Amount you owe.** Subtract line 72 from line 61. For details on how to pay, see instructions ▶	76	
77	Estimated tax penalty (see instructions) 77		

Third Party Designee

Do you want to allow another person to discuss this return with the IRS (see instructions)? ☐ **Yes.** Complete below. ☐ **No**

Designee's name ▶ Phone no. ▶ Personal identification number (PIN) ▶

Sign Here

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Joint return? See instructions. Keep a copy for your records.

Your signature	Date	Your occupation	Daytime phone number
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	If the IRS sent you an Identity Protection PIN, enter it here (see inst.)

Paid Preparer Use Only

Print/Type preparer's name	Preparer's signature	Date	Check ☐ if self-employed	PTIN
Firm's name ▶		Firm's EIN ▶		
Firm's address ▶		Phone no.		

APPENDIX B

2011 Tax Rate Schedules (Service, 2011a)

2011 Tax Rate Schedules

CAUTION

The Tax Rate Schedules are shown so you can see the tax rate that applies to all levels of taxable income. Do not use them to figure your tax. Instead, see the instructions for line 44.

Schedule X—If your filing status is **Single**

If your taxable income is: Over—	But not over—	The tax is:	of the amount over—
$0	$8,500	.... 10%	$0
8,500	34,500	$850.00 + 15%	8,500
34,500	83,600	4,750.00 + 25%	34,500
83,600	174,400	17,025.00 + 28%	83,600
174,400	379,150	42,449.00 + 33%	174,400
379,150	....	110,016.50 + 35%	379,150

Schedule Y-1—If your filing status is **Married filing jointly** or **Qualifying widow(er)**

If your taxable income is: Over—	But not over—	The tax is:	of the amount over—
$0	$17,000	.... 10%	$0
17,000	69,000	$1,700.00 + 15%	17,000
69,000	139,350	9,500.00 + 25%	69,000
139,350	212,300	27,087.50 + 28%	139,350
212,300	379,150	47,513.50 + 33%	212,300
379,150	....	102,574.00 + 35%	379,150

Schedule Y-2—If your filing status is **Married filing separately**

If your taxable income is: Over—	But not over—	The tax is:	of the amount over—
$0	$8,500	.... 10%	$0
8,500	34,500	$850.00 + 15%	8,500
34,500	69,675	4,750.00 + 25%	34,500
69,675	106,150	13,543.75 + 28%	69,675
106,150	189,575	23,756.75 + 33%	106,150
189,575	....	51,287.00 + 35%	189,575

Schedule Z—If your filing status is **Head of household**

If your taxable income is: Over—	But not over—	The tax is:	of the amount over—
$0	$12,150	.... 10%	$0
12,150	46,250	$1,215.00 + 15%	12,150
46,250	119,400	6,330.00 + 25%	46,250
119,400	193,350	24,617.50 + 28%	119,400
193,350	379,150	45,323.50 + 33%	193,350
379,150	....	106,637.50 + 35%	379,150

APPENDIX C

Sample Flat Tax Forms (Mitchell, 2005)

Figure 1 B 1866

Simplicity on a Postcard: Sample Flat Tax Forms

Form 1 — Individual Wage Tax — 2005

Your first name and initial (if joint return, also give spouse's name and initial)	Last name	Your social security number
Home address (number and street including apartment number or rural route)		Spouse's social security number
City, town, or post office, state and ZIP code		Your occupation / Spouse's occupation

1 Wages, Salary and Pensions	1	
2 Personal allowance		
(a) $20,000 for married filing jointly	2(a)	
(b) $10,000 for single	2(b)	
(c) $13,000 for single head of household	2(c)	
3 Number of dependents, not including spouse	3	
4 Personal allowances for dependents *(line 3 multiplied by $6,000)*	4	
5 Total personal allowances *(line 2 plus line 4)*	5	
6 Taxable wages *(line 1 less line 5, if positive; otherwise zero)*	6	
7 Tax *(17% of line 6)*	7	
8 Tax already paid	8	
9 Tax due *(line 7 less line 8, if positive)*	9	
10 Refund due *(line 8 less line 7, if positive)*	10	

Form 2 — Business Tax — 2005

Business name	Employer identification number
Street address	County
City, town, or post office, state and ZIP code	Principal product

1 Gross revenue from sales	1	
2 Allowable costs		
(a) Purchases of goods, services, and materials	2(a)	
(b) Wages, salaries, and retirement benefits	2(b)	
(c) Purchases of capital equipment and land	2(c)	
3 Total allowable costs *(sum of lines 2(a), 2(b), and 2(c))*	3	
4 Taxable income *(line 1 less line 3)*	4	
5 Tax *(17% of line 4)*	5	
6 Carry-forward from 2004	6	
7 Interest carry-forward *(6 percent of line 6)*	7	
8 Carry-forward into 2005 *(line 6 plus line 7)*	8	
9 Tax due *(line 5 less line 8, if positive)*	9	
10 Carry forward to 2006 *(line 8 less line 5, if positive)*	10	

Source: Based on Robert Hall and Alvin Rabushka, *The Flat Tax* (Stanford: The Hoover Institution Press, 1995)

APPENDIX D

The Flat Tax Abroad (Mitchell, 2007)

FLAT TAX JURISDICTIONS	YEAR OF ENACTMENT	TAX RATE
Jersey	1940	20 percent
Hong Kong	1947	16 percent
Guernsey	1960	20 percent
Estonia*	1994	22 percent
Latvia	1995	25 percent
Lithuania**	1996	27 percent
Russia	2001	13 percent
Serbia	2003	14 percent
Slovakia	2004	19 percent
Ukraine***	2004	15 percent
Iraq	2004	15 percent
Romania	2005	16 percent
Georgia	2005	12 percent
Iceland	2007	35.7 percent
Mongolia	2007	10 percent
Kyrgyzstan	2007	10 percent
Macedonia	2007	12 percent
FUTURE FLAT TAX JURISDICTIONS	**GOES INTO EFFECT**	**TAX RATE**
Montenegro	2007 (July)	15 percent
Mauritius	2009	15 percent

*Originally 26 percent. **Originally 33 percent. ***Originally 13 percent.

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